STATE OF ILLINOIS
SECRETARY OF STATE
SECURITIES DEPARTMENT

In the matter of UBS Securities, LLC and UBS Financial Services, Inc. Respondent.	)	**Case Number:** 08-00191

NOTICE OF HEARING

TO THE RESPONDENT: UBS Securities, LLC and UBS Financial Services Inc.

You are hereby notified that, pursuant to Section 11.F of the Illinois Securities Law of 1953 [815 ILCS 5] (the "Act") and 14 Ill. Adm. Code 130, Subpart K (the "Rules"), a public hearing will be held at 69 West Washington Street, Suite 1220, Chicago, Illinois 60602, on the 9th day of November, 2011, at the hour of 10:00 a.m., or as soon thereafter as counsel may be heard, before James L. Kopecky, or another duly designated Hearing Officer of the Secretary of State.

This hearing will be held to determine whether an Order shall be entered against the Respondent in the State of Illinois and/or grant such other relief as may be authorized under the Act including but not limited to imposition of a monetary fine in the maximum amount pursuant to Section 11.E(4) of the Act, payable within ten (10) business days of the entry of the Order.

The grounds for such proposed action are as follows:

FINDINGS OF FACT

1. UBS Securities, LLC ("UBS Securities") and UBS Financial Services, Inc. "UBS Financial Services") (collectively "UBS") are broker-dealers registered in the state of Illinois, with Central Registration Depository ("CRD") numbers of 7654 and 8174 respectively.

2. Illinois has been a part of coordinated investigations conducted by a multistate task force ("task force") into UBS activities in connection with its sales of financial products known as auction rate securities ("ARS") to retail and other customers.

3. UBS admits to the jurisdiction of the Department in this matter.

How UBS Marketed and Sold its ARS to its Clients

(1.) UBS Wealth Management's FAs Represented ARS to Clients as Safe, Liquid, Cash Alternatives to Money-Market Instruments

4. UBS Customers in Illinois were sold ARS and, in most instances, were told they were safe liquid money-market instruments.

5. Many UBS customers were told that the interest rates on these instruments were set periodically through the functioning of deep, liquid, fully functioning auctions that had never failed for 20 years. Some were not told about the auction process at all, but simply thought they were buying short-duration instruments.

6. Many UBS customers were not told that the majority of the auction rate products available to them were limited to ARS that UBS underwrote.

7. Many UBS customers were not apprised of the risks of ARS, including risk of failed auctions or a market freeze.

8. Many UBS customers were not told that UBS had a policy of placing support bids in every auction for which it was the sole or lead broker-dealer, that UBS routinely intervened in the auction markets to set the interest rates, that certain potential conflicts of interest existed between UBS and its customers, that in August of 2007 UBS changed its policy of placing support bids in every auction for which it was lead broker-dealer and allowed some of the ARS it had underwritten to fail, or that in November of 2007 UBS was actively considering scenarios that included ceasing its practice of supporting its auctions.

9. After UBS decided to stop supporting its auctions, these clients were informed that the market for these instruments had frozen and that they no longer held liquid short-term instruments but instead held instruments with long or perpetual maturities for which no market existed. Many of those instruments are no longer valued at par on UBS Financial Services account statements.

(2.) UBS Brokers who sold ARS to Clients understood them to be Safe, Liquid Cash Alternatives or Money Market Instruments.

10. The UBS Financial Services Financial Advisors ("FAs") that the task force

Interviewed had not received and specific instruction or compliance training from UBS with respect to ARS.

11. Many of the FAs that the task force interviewed did not have even the most basic understanding of how ARS worked until after UBS pulled out of its auctions in February of 2008.

(3.) UBS Did Not Provide its Financial Advisors With Any Mandatory Training With

Respect to ARS.

12. UBS did not provide its FAs with mandatory training regarding ARS.

13. In testimony provided to the task force, the Director of Product Management for UBS Financial Services ("Director of Product Management") indicated a wide range of information that FAs should know prior to selling ARS to customers including the issuer's identity, the type of ARS, the credit quality, how the auction process works, and that a customer bid may or may not get filled for that auction.

14. However, UBS did not provide mandatory training or specifically instruct its FAs to apprise themselves of this information or provide customers with the information.

(4.) UBS Marketed ARS to Clients as Safe, Liquid Instruments

15. The UBS clients with whom the task force spoke uniformly stated that ARS had been marketed to them as completely liquid, safe money-market type instruments.

16. UBS Financial Services posted on it public website a marketing piece "Cash & Cash Alternatives Addressing Your Short-Term Needs," which included Auction Preferred Stock and Variable-Rate Demand Obligation as cash alternative.

17. Similarly, in August 2007 UBS circulated its "Investment Intelligence" magazine, which is "a quarterly 'statement stuffer' that is sent to all [UBS Financial Services] retail clients and available to employees on the internet." The featured topic was "Planning Your Retirement Cash Flow Strategy." The Feature included Auction Preferred Stock, Auction Rate Certificates, and Variable-Rate Demand Obligations as cash alternatives. It also invited customers to request a copy of Putting Liquidity to Work: A Guide to Cash Alternatives, which is a brochure UBS made available to Financial Advisors to provide to clients starting in 2004, and which was posted on its external website in October 2007. This brochure identified a number of risks relating to ARS, including the risk of auction failure, UBS's routine support of the auctions, the lack of any obligations that UBS continue to support the market, and the conflicts of interest arising from UBS's multiple roles in the auction market.

(5.) ARS Were Listed Under the Heading "Cash Alternatives/ Money Market Instruments" on UBS Financial Services Client Statements Through January 2008

18. Through January 2008, the client statements issued to retail customers listed APS under the heading: "Cash Alternative/Money Market Instruments."

19. In the February 2008 client statements, UBS removed the heading "Cash Alternative/Money Market Instruments" from its clients statements. ARS were then referred to as "Cash Alternatives/Other."

20. For the May 2008 and subsequent statements, the heading on UBS Financial Services account statements under which ARS appeared was changed again to "Fixed Income/ARS."

21. Student-loan auction rate certificates ("Student Loan ARCS") had been listed under the heading "Cash Alternatives/Municipal Securities." This heading was changed to "Fixed Income/ARS."

(6.) UBS Did Not Disclose Aspects of its ARS Program to its Clients

22. UBS did not have any mandatory disclosures regarding ARS that its FAs were required to make.

23. On this topic, the Director of Product Management testified that FAs were not required by any specific policy to inform clients of the possibility that auctions may fail. He said that he did not believe that FAs were required to inform clients that UBS Securities routinely intervened in the auction markets to prevent failure and to place a ceiling on clearing rates. He also testified that UBS Financial Services FAs were not informed that UBS Securities's inventory of ARS had exceeded the $2.5 billion cap,

though FA's would have been able to tell that UBS's inventory was growing rapidly in January and February 2008 through the trading systems available to them.

B. UBS's ARS Program Was Inconsistent With How It Was Promoted to Clients and Financial Advisors

(1.) Background on Mechanics of ARS

a. Dutch Auction Process

24. A Dutch auction is a competitive bidding process used to determine rates of interest on an instrument on each auction date. Bids are submitted to the auction agent by the investors interested in buying or selling their securities. The auction agent matched purchase and sale bids and the winning bid is the highest price (equivalent to the lowest rate) at which the auction clears. At the auction a holder may submit one of the following orders:

- **Hold Order** – the holder wishes to continue to hold a position regardless of rate.

- **Hold Rate Order or Bid Order** – the holder only wishes to continue to hold a

position or purchase a new position if the new rate is equal to or higher than a specified rate.

- **Sell Order** – directs the broker-dealer to redeem the position at par regardless of the new rate.

b. <u>Types of Auction Rate Securities</u>

(i) Auction Preferred Shares ("APS")

25. APS are equity instruments without a stated maturity issued by closed-end funds. They are collateralized by the assets in that fund and typically receive ratings from the major rating agencies. Interest rates are intended to be set in a Dutch auction process with auction cycles typically of 7 or 28 days. Typically, they have a maximum rate above which the interest rate cannot be set in an auction.

(ii) Municipal Auction Rate Certificates

26. Municipal auction rate certificates ("Municipal ARCS") are debt instruments (typically municipal bonds) issued by governmental entities with a long-tem nominal maturity and a floating interest rate that is intended to be reset through a Dutch auction process. They receive long-term ratings from the major rating agencies and are often backed by monocline insurance.

(iii.) Student Loan-Backed Auction Rate Certificates

27. Student Loan-backed auction rate certificates ("Student Loan ARCS") are long-term debt instruments issued by trusts which hold student loans. Interest rates are intended to be set in a Dutch auction process, and typically Student Loan ARCS have a maximum rate above which the interest rate cannot be set in an auction. They receive long-term rating from the major rating agencies.

28. References to ARS herein shall include three separate categories of instruments: APS of closed-end funds, Municipal ARCS, and Student Loan ARCS.

(2.) UBS's ARS Program

a. Underwriting

29. UBS Securities was one of the largest underwriters of Municipal ARCS and Student Loan ARCS.

30. UBS Securities was a large underwriter of APS until it ceased underwriting those shares in 2005 or 2006.

31. UBS's compensation for underwriting ARS was typically one percent of the amount underwritten.

32. UBS competed with other investment banks to provide low-cost financing to ARS issuers. Its ability to do so was a key factor in its ability to generate additional ARS underwriting business.

b. Broker-Dealer Agreements

33. For the ARS that it underwrote, UBS Securities typically serves as a manager of those auctions.

34. UBS Securities often served as lead manager, but sometimes served as co-manager of auctions with other large-broker dealers.

35. UBS Securities's management responsibilities were typically set forth in an agreement called a broker-dealer agreement that it entered into with the issuer.

36. UBS Securities's compensation under those broker-dealer agreements was typically 20-25 basis points annualized of the amount managed.

37. UBS Securities shared a portion of its management fee with UBS Financial Services and its Financial Advisors in connection with the sale of ARS to customers of UBS Financial Services.

c. Distribution of ARS by UBS Financial Services

38. UBS Financial Services served as the primary distribution source for the ARS that UBS Securities underwrote.

39. Most of the ARS sold to clients of UBS Financial Services came from UBS Securities's ARS program.

40. UBS Financial Services did not do its own due diligence to discern whether particular ARS were quality instruments to be offered to its retail clients.

41. The Director of Product Management testified that since joining UBS Financial Services in 2005, he could not recall any instance in which UBS Financial Services had rejected or declined to distribute to its customers an ARS product underwritten by UBS Securities.

42. FAs received a portion of 25 basis points annualized of the total amount of ARS held by their Clients.

43. FAs received no commission for their clients' investments in UBS's standard money market fund.

d. UBS Routinely Placed Support Bids in Order to Prevent Failed Auctions

44. On all of the auctions for which it was the sole or lead broker-dealer, UBS Securities placed support bids to ensure that the auctions would not fail.

45. According to information provided by UBS to the task force, in auctions for APS from January 1, 2006 through February 28, 2008, UBS Securities submitted support bids in 27,069 auctions. The support bids were drawn upon in order to prevent a failed auction 13,782 times, which represented 50.9 percent of those auctions.

46. According to information provided by UBS to the task force, in auctions for Municipal ARCS and Student Loan backed ARCS from January 1, 2006 through February 28, 2008, UBS Securities submitted support bids in 30,367 auctions. The support bids were drawn upon in order to prevent failed auctions 26,023 times, which represented 85.7 percent of those auctions.

47. If UBS had not placed support bids in auctions, UBS's auction rate program would have failed.

e. UBS's Setting of Interest Rates

(i.) Price Talk

48. Prior to every auction for which it was the sole or the lead broker-dealer, UBS engaged in price talk. Price talk consisted of a range of bids that UBS Securities

transmitted to UBS Financial Services's FAs indicating where UBS Securities expected the auctions to clear.

(ii.) Setting Interest Rates by Placing Bids

49. UBS influenced ARS interest rates by submitting buy and sell bids from its own inventory.

50. UBS's Short Term Desk frequently set the rate at which the auction would clear.

51. In the Fall of 2007, UBS raised the interest rates it set on ARS in part in response to a buildup of inventory of ARS.

52. In contrast to the understanding that retail investors were given that the interests rates on these securities were actually set through the auction process, the Head of Short-Term Training said, "We are making pricing decisions based on our ability to attract investors while managing issuer client relationships and will continue to do so in efforts to move securities."

(3.) In August 2007 UBS Intentionally Allowed Certain of its Auctions to Fail

53. In August 2007, a number of broker-dealers, including UBS, failed some of their auctions for certain auction products that were issued in private placements relating to the CDO market and certain auction products issued by monoline insurance companies.

54. In August 2007, UBS intentionally allowed to fail the auctions for sixteen (16) CUSIPS.

55. These same auctions continued to fail in the Fall of 2007.

(4.) UBS's Inventory of ARS Increased Substantially from August 2007 through mid-February 2008

a. Inventory Increased Beyond Cap Imposed by Risk Management

56. UBS's inventory of ARS, which it added to each time it supported an auction that otherwise would have failed, began to increase after the auction failures in August 2007.

57. UBS's risk-control division imposed limits on the amount of auction rate inventory UBS could hold.

58. When the inventory obtained by supporting auctions was reached, the Short-Term Desk had to request from risk-management an increase in that cap.

59. UBS's support of the auctions caused its inventory of ARS to increase even more in 2008.

b. Pushback from Risk Management

60. In the fall of 2007 and the beginning of 2008, UBS's risk management group was beginning to express concerns about the increase in the buildup of ARS. Risk management expressed these concerns in the context of the short-term desk's repeated requests to take on inventory of ARS above the caps imposed by risk management.

61. For example, an email dated August 15, 2007 from an employee in the investment bank's risk function (who worked with the investment bank's Chief Risk Officers in the Americas), stated: "Limited extension [of permission to operate over peak auction rate security inventory limit] granted for one night. There is little tolerance for increased inventory firm wide; please continue to price aggressively to keep inventory down."

(5.) UBS Attempted to Limit the Buildup of Auction Rate Securities Inventory

a. Enhanced Marketing Efforts for ARS

62. As UBS's inventory of ARS began to grow, the Global Head of UBS's Municipal Securities Group led an effort to sell more of that inventory.

63. This effort began in August 2007 and continued until UBS pulled out of the market in February 2008.

64. A concerted marketing effort was made to get the FAs to sell ARS.

65. In early 2008, in response to a substantial decrease in corporate cash demand for ARS, UBS began an education campaign to ensure the FAs understood the true credit quality of the ARS.

b. Waivers of Maximum Rates on Student-Loan Backed Auction Rate Certificates

66. The maximum rate at which Student Loan ARCS could reset was too low to compensate investors for the perceived risk of those instruments during the period between August 2007 and February 2008. Many APS suffered from a similar flaw.

67. These maximum rates were well known to UBS as UBS Securities had built them into the instruments in order to make them more palatable to their underwriting clients.

68. The maximum rates often allowed the issuers to obtain a higher rating on the product in part because capping the interest rate on the product allowed them to satisfy the cash flow stress-tests of the rating agencies.

69. As investors shied away from ARS after August 2007, UBS's inventory began to grow dramatically and it needed to keep rising interest rates in order to move the paper.

70. However, as those interest rates began to approach the maximum rates on the securities with restrictive maximum rates, UBS began an effort to get its issuer clients to agree to a temporary increase in maximum rated and to seek waivers from the rating agencies in order to allow the interest rates of those instruments to rise to a level where those instruments could clear the market, until the market recovered or UBS could work with issuers to restructure.

71. Those waivers were short-term in nature and many that had been obtained in 2007 were set to expire in early 2008.

72. UBS became very concerned that when these waivers expired, these instruments would hit the maximum rate and the rate would reset to a level that would not be appealing to investors, thus requiring UBS to take on even more Student Loan ARCS.

73. In January 2008, UBS continued to seek waivers of the maximum rates from issuers.

74. UBS did not disclose its concerns with respect to maximum rates of Student Loan ARCS to investors.

75. Moreover, UBS's FAs were not aware of issues related to the maximum rate and did not explain them to customers.

(6) After August 2007, UBS's Concerns Regarding ARS Intensified Causing UBS to Debate Its Ongoing Role in the Auction Markets

76. After August 2007, there was ongoing dialogue within UBS as to the condition of the auction markets, with particular emphasis on Student Loan ARCS.

77. In the Summer and Fall of 2007, UBS began a balance sheet reduction program, which required all divisions, including the short-tem desk, to contribute to liquidity creation and balance sheet reduction.

78. By early December 2007, it became clear that many institutional buyers were no longer interested in ARS.

79. On December 12, 2007, the Head of Flow, Sales and Trading sent an email to the Global Head of Municipal Securities in which he stated: "The auction

product does not work and we need to use our leverage to force the issuers to confront this problem our options are to resign as remarketing agent or fail or?"

80. Of note, that same day, the Global Head of Municipal Securities sold his remaining personal shares of ARS while continuing to engage in enhanced marketing efforts to clients. He subsequently explained that he made these sales because "my risk tolerance from a credit perspective was – was something that drove me to want to sell" ARS.

81. A student loan task force was set up at UBS in mid-December 2007.

82. In addition to the student loan task force, in December 2007, a working group was convened to discuss the broader condition of UBS's ARS program. According to UBS's response to interrogatories propounded by the task force, "In late 2007, UBS formed a working group that addressed the general market conditions for ARS, as well as UBS' continued role in ARS auctions."

83. The working group held meetings on December 21, 2007, January 4, 2008, January 18, 2008, February 1, 2008 and February 29, 2008.

84. The working group discussed, among other things, the buildup in UBS's inventory of ARS and strategies for exiting the auction markets.

(7.) UBS's Conflicted Role in Serving Underwriting Clients Versus Acting in the Best Interests of Retail Wealth Management Clients

85. UBS's auction rate program, in which it actively managed to influence the interest rates on ARS (which interest rates, in theory, should have been set by auctions), put in a fundamentally conflicted role.

86. On one hand, as set forth in detail above, UBS often needed to raise interest rates in order for auction paper to clear. On the other hand, if UBS raised interest rates too high, it ran afoul of its underwriter clients, to whom it had promised low-cost financing.

87. Many UBS Financial Services's investors were unaware of this conflict, as it was never disclosed to them.

88. Many retail purchasers of UBS auction rate paper thought that the interest rates were set by the auction markets, not by UBS's setting of the interest rates resulting from its balancing of the needs of its underwriting clients and its needs to move the product so that its inventory did not grow too large.

89. This conflict became more acute when the auction markets began to crumble. If UBS did not raise rates enough, there would not be sufficient buying interest and UBS would have to take more auction rate paper onto its books. If UBS raised rates too high, the auction results could significantly increase the cost of financing to UBS's issuer clients.

(8.) UBS Financial Advisors Were Not Apprised of this Back Story

90. As the auction rate market began to show some stress in August 2007, which gained intensity through the end of 2007 and January 2008, many customers were not informed of problems in the ARS market.

91. Up through at least February 8, 2008, and in connection with updates to FAs of events occurring in the auction rate market, FAs were informed as follows:

> The public auction market continues to clear hundred of auctions daily, with lead-broker-dealers frequently bidding to clear auctions where needed. While broker-dealers are not obligated to bid in auction, we do not have reason to change our current practice when UBS is lead underwriter. We will continue to monitor developments so that we responsibly serve our clients and shareholders.

92. This message came one day after the Global Head of Municipal Securities, in a February 7, 2008 email to certain UBS personnel on the topic of whether UBS was contemplating failing auctions, stated, regarding the auction rate market: "clock ticking-not sustainable."

93. In stark contrast to the sales of personal holding of ARS by the Global Head of Municipal Securities in August and December 2007, customers who were kept in the dark about UBS's concern about the viability of the program and UBS's wavering commitment to the program, found themselves stuck.

(9) UBS Failed Its Auctions On February 13, 2008

94. UBS Financial Services's FAs kept selling ARS through February 12, 2008.

95. On February 13 2008, without prior notice to its customers who had purchased ARS, UBS failed its auctions for ARS.

IV.

ALLEGATIONS OF LAW

1. Illinois has jurisdiction over this matter pursuant to the Illinois Securities Law of 1953 [815 ILCS 5] (the "Act").

2. The Illinois Securities Department finds that the above conduct subjects UBS to sanctions under 8.E.(1)(b) for unethical practice in the offer and sale of securities, and 8.E.(1)(e)(iv) for failure to supervise.

3. The Illinois Securities Department finds the following relief appropriate and in the public interest.

A copy of the Rules and Regulations promulgated under the Illinois Securities Law and pertaining to hearings held by the Office of the Secretary of State, Illinois Securities Department, are available at http://www.ilga.gov/commission/jcar/admincode/014/01400130sections.html, or upon request.

Delivery of Notice to the designated representative of the Respondent constitutes service upon such Respondent.

Dated: This 10th day of August, 2011.

Jesse White
Secretary of State
State of Illinois

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